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Rent Growth Slows a Bit In Sluggish Office Market

By Ryan Chittum
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The pace of rent growth in the nation's office buildings slowed in the third quarter, and leasing was sluggish as companies tapped the brakes on expansion due to credit-market turmoil and uncertainty about the economy's direction.

Although rent growth remained healthy in the third quarter, up 2.4% to \$24.17 per square foot from \$23.61 in the second quarter, it was off the pace set in the first six months of the year, when rents grew an average 3% per quarter, according to a survey of 79 of the top U.S. office markets by Reis Inc., a New York-based commercial real-estate research firm.

That, combined with sluggish growth in office-based employment over the last several months, raises concern about the direction of the market at a critical time for real-estate investors, though it is too early to tell if it is a one-quarter blip or something worse, says Sam Chandan, chief economist for Reis.

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For now, the three-and-a-half year old office recovery is still under way, if showing signs of weakness. The vacancy rate hit its lowest level in six years, dropping to 12.5% in the third quarter from 12.7% in the second quarter, though the pace of absorption -- the change in the total amount of space leased nationwide -- slowed. Absorption totaled 14.8 million square feet in the third quarter compared to 17.3 million in the second.

"There is a slowdown," said Barry M. Gosin, chief executive of Newmark Knight Frank, a New York-based commercial real-estate

services firm. "Any major financial institution is not in a hurry to rent space right at the moment."

Strong rent growth was found only in pockets. Just eight markets showed rent increases equal to or above the nationwide average of 2.4%. The median rent change was 1.1%. Texas office markets are particularly hot. Austin led the nation in rent growth at 5.6%. Houston and Dallas were fourth and 17th, respectively.

But even in Austin there's been something of a pullback. "We're starting to see short-term renewals and people not have the confidence to step up and buy into the current environment," says John Childers, a Austin-based broker with the Staubach Co., a tenant representation firm.

Nationwide, the office market has benefited from relatively restrained new construction. Completions of new office buildings brought 12.2 million square feet of space onto the market in the third quarter, about average for the last year but well below the peak in 2001, when 47.1 million square feet opened in the fourth quarter. Yet, there are signs that the pace will quicken in the next several quarters as delayed projects are finished, Mr. Chandan says.

Before the subprime mortgage crisis metastasized into a full-blown credit crunch, office-building investors spent freely and lenders financed their purchases based on expectations of future rather than present cashflow -- a practice that has not been the norm historically. In the second quarter, the average securitized office loan was based on cashflow inflated 14% in expectation of soaring rents, Mr. Chandan says.

If rent growth continues to slow over the next few quarters, investors who made these aggressive purchases could face trouble covering their debt payments, especially since many of the purchases were made with historically low levels of equity.

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